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Swiss rate reform in race against the clock

Time constraints and valuation headaches complicate swaps market transition from Tois to Saron

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NEED TO KNOW

- Switzerland plans to replace its existing overnight indexed swap rate from Tois to Saron at the end of the year.
- This change requires a number of amendments to current market practice, which some fear will not be completed in time.
- The legal framework around the new Saron swaps has to be created, but liquidity is expected to be poor initially, which will slow the market's growth.
- Existing Tois-linked swaps are likely to be changed to reference Saron. The market is waiting for Isda to provide guidance on how to approach this task.
- But Tois is also used as a discount and collateral interest rate for cash-collateralised, Swiss franc Libor-linked interest rate swaps.

- Saron is 20 basis points lower than Tois, which is raising fears of large valuation changes for existing portfolios, with no compensation.
- Some traders expect Tois and Saron to converge by 2018, reducing the impact.
- Not everyone agrees with that assessment. Cardano's Max Verheijen suggests firms restrike existing swaps before changing the discount rate to minimise the valuation impact.

Switzerland is known to take time-keeping seriously. But with the transition to a new overnight indexed swap (OIS) rate set for the end of the year, the local swap market is in danger of missing an important deadline.

From December 30, the current unsecured tomorrow/overnight index (Tois) fixing will be discontinued owing to a dwindling number of transactions and contributors. Before its secured replacement, the Swiss average rate overnight (Saron), can fully take over as the new OIS rate for the Swiss market, however, a number of steps must be completed.

The International Swaps and Derivatives Association must first deliver a new legal framework for swaps using Saron as the reference rate. Then the broker market needs to work out the various term structures required for Saron swaps, though with trading volume expected to be low initially – partly a result of the lack of term structures – the market is stuck in a chicken-and-egg situation. Clearing houses also must develop and deliver a new Saron curve on which OIS discounting can be based.

Dealing with existing trades is expected to prove more difficult. Given Tois can serve as a reference rate for a swap as well as the discount rate and collateral interest rate for Swiss franc cash-collateralised trades, existing collateral agreements, known as credit support annexes (CSAs), will also have to change. But industry observers say there is too much to do in too little time.

"I strongly doubt that everything will be completed in less than a year," says Marc Henrard, an advisory partner at OpenGamma, a provider of risk analytics solutions. "If they stop publishing Tois they will force the transition on the market, but doing that could create disputes that drag on for years afterwards."

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Then there is the matter of **valuation changes**. Altering the discount and collateral interest rate on existing swaps can have a significant impact on the present value of the future cash flows of existing swaps. Saron is 20 basis points below Tois at present, and while many believe the rates will converge, others worry they may not.

If there is a valuation difference, the Working Group on Swiss Franc Reference Interest Rates, a sub-group of a national working group that is overseeing wider rates reform, recommends there be no compensation payments, pointing out these would be “difficult to determine and virtually impossible to enforce”.

While these are just recommendations, and any decision would be up to the counterparties themselves, some buy-side entities will be looking for redress.

“I noticed it has been suggested that there should be no remuneration or compensation for the change. That is strange to me, because in the euro market we have always been compensated,” says Max Verheijen, head of financial markets at pension fund asset manager Cardano in Amsterdam, which manages financial risks for Swiss pension fund Vita. “If you change, for example, from a bond CSA to a cash CSA, that has an influence on the mark-to-market of your portfolio and you have to be compensated for that.”

Slow start

Given only seven banks were left participating in the Tois fixing, there was an air of inevitability about Switzerland’s decision early last year to look for an alternative overnight rate. After efforts to find additional contributors proved unsuccessful, the rate’s administrator, ACI Suisse, concluded the Tois fixing was unsustainable over the long-term and announced it would be discontinued after December 29.

The Working Group on Swiss Franc Reference Interest Rates picked a secured rate, **Saron**, as the new OIS rate for the Swiss market. While the decision was taken in the first quarter of 2016, it was not until ACI Suisse made its announcement to end Tois that the clock really began ticking.

Since then, swaps users have been busily preparing for the switch to the new rate. The biggest issue has been the treatment of trades linked to Tois that mature after its fixing ends. The most obvious impact is on trades where Tois is the reference rate, such as in a Tois-to-fixed swap or a Tois-Libor basis swap.

An Isda working group that includes representatives from the cleared and non-cleared markets is facilitating the **transition of existing Tois swaps** to reference Saron, which is what the group recommends for legacy swaps that mature after the Tois fixing closes. Isda told *Risk.net* in early February that it aims to finalise and publish guidance in the first quarter of this year, but it is unclear what form this will take.

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> **Olek Gajowniczek, Nomura**

"While the Isda working group is not obliged to adopt the recommendation from the national working group and no final decision has yet been made, there does seem to be broad support for it in principle. How any decision is implemented is also yet to be agreed; it may be that a guidance note is issued and a template provided for parties to make changes to their contracts on a bilateral basis," said Rick Sandilands, Isda's senior counsel for Europe.

The move will require repapering of CSAs with a host of clients, but dealers say they are stuck in a holding pattern until they receive guidance from Isda on how to proceed.

"We are still in a waiting phase," says an interest rate swaps trader at one European bank in London. "We hope we can start renegotiating and amending all our CSAs in the near future. But before we can do that, we have to wait on the Isda recommendations so that we can put the contracts in the same language."

The legal framework allowing for the trading of new Saron-linked swaps will also need to be established, which will involve the addition of a compound rate definition of Saron to the Isda 2006 definitions. But dealers believe bilateral trading will be slow to take off even once the framework is in place. One likely barrier is the absence of historical trading data on Saron swaps, which makes creating a term structure for the new instruments difficult and, in turn, discourages trading. It is a "Catch-22" situation, says Olek Gajowniczek, an executive director of cross-currency basis swaps at Nomura in London.

"For some market participants, it is clearly going to be quite difficult to book these things to begin with," says Gajowniczek. "It isn't easy to calculate things like value-at-risk without any observable history of Saron swaps. The work on that front hasn't necessarily been done yet."

Appetite to become an early adopter of Saron swaps is likely to vary across institutions. "Banks have different levels of motivation to get this product going," says Tim Nicholson, a senior associate at Gottex Brokers in Lausanne. "The banks for whom it is more peripheral don't really need to rush this through and be ready quite as soon as those that have a bigger involvement with the Swiss franc, such as the cantonal and larger Swiss banks."

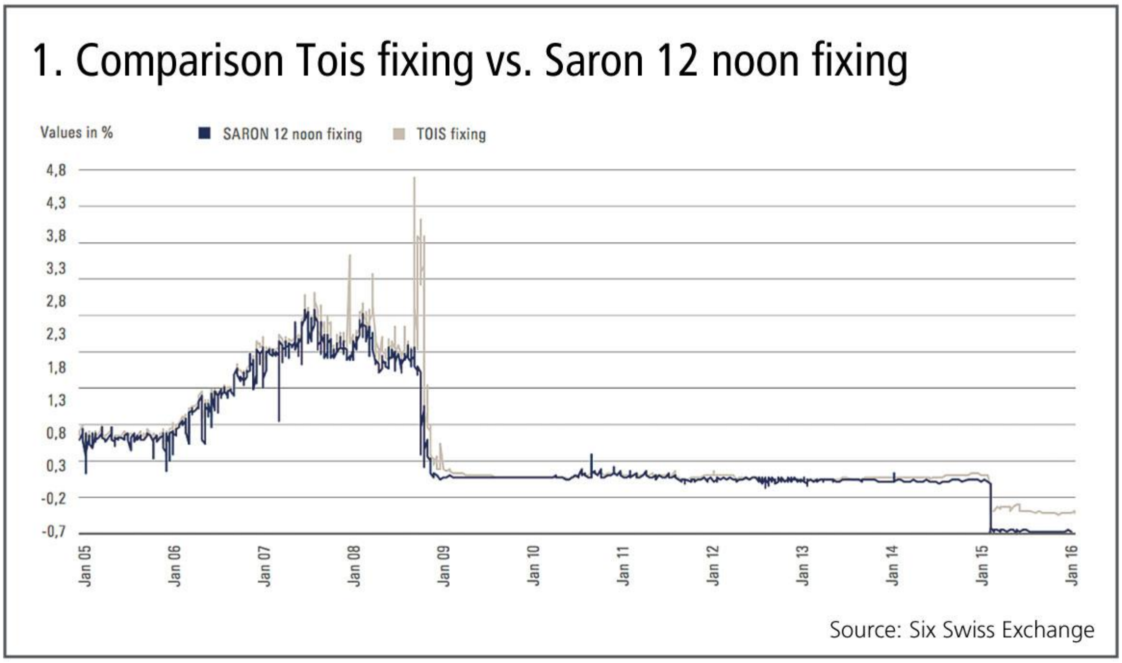
Pricing the change

An initial dearth of liquidity for Saron swaps is not the only challenge facing the market. Tois is also used as the discount rate and interest rate received on posted variation margin for swaps collateralised with Swiss franc cash.

This includes Swiss franc Libor-linked interest rate swaps. These instruments are traded far more widely than Tois swaps and can trade at long maturities. Clearing house LCH, which has Sfr1.97 trillion ($1.96 trillion) notional of Swiss franc interest rate swaps outstanding, is understood to be developing a new Saron discounting curve to replace Tois once the fixing ends. But any change would be subject to approval by its members. LCH declined to comment.

It's unclear how changes to the discount rate in bilateral trades would be undertaken.

The current difference between Saron and Tois at spot is 20bp, suggesting the impact on the present value of collateralised trades could be significant, especially for long-dated contracts.



In 2014, a report published by the Market Participants Group on Reforming Interest Rate Benchmarks, established by the Financial Stability Board, surveyed market participants on **basis-point variation**. It found that where a reformed benchmark systematically differed from the current benchmark by only 5bp, a majority of respondents were either undecided on whether they would transition to the new rate (48%) or preferred to transition to a different rate (12%).

Some, however, argue the issue is not as problematic as it might at first appear. Nomura's Gajowniczek says the price of new long-dated Tois-Libor basis swaps already assumes the two rates will converge when the Tois fixing ends, meaning the overnight leg will effectively fall 20bp by the end of the year.

"The market is effectively already pricing the change," he says. "Those are instruments most derivatives users will be using to mark-to-market the funding of their derivatives portfolios, and [they] imply a convergence of the overnight rate to the prevailing level of Saron."

The European bank's interest rate swaps trader agrees, saying traders are positioning for a widening of the basis between Swiss franc Libor and the Swiss overnight rate: "Everyone wants to have wideners on their book at the moment. When we are trying to trade fixed versus Tois, this is generally the side of the market that people are on. There is likely to be some sort of convergence, although it's unlikely to be complete."

This view corresponds with that of the Swiss working group, which stated in February that it expects “on a theoretical basis” to see some convergence in the forward markets of Tois and Saron over the course of 2017.

Saron strategies

Cardano’s Verheijen, on the other hand, believes the spot price of Tois and Saron may not converge significantly over the coming months – an issue he says is likely to loom large for any buy-side firm using Swiss franc interest rate swaps in the months ahead.

“A 20bp difference on, say, a contract of 30 years is very significant – it is around 6% over your mark-to-market,” he says. “To me, it makes sense that if you change your curve – and it is such a big difference – then this should be reflected in the mark-to-market of your portfolio. So that is something the buy side absolutely needs to give some thought to in the coming months.”

If the rates fail to converge fully then the result will be a difference in present values, but the Swiss working group has recommended there be no compensation for the party that suffers a loss.

It argues that Saron may be a more appropriate proxy than Tois for the risk-free rate used for discounting collateralised derivatives cash flows. Saron is, after all, a secured overnight rate, and is therefore free of counterparty risk. Any change in present values, the working group said in a recent statement, would therefore be due to “a weakness of the valuation model used, rather than an effect of the transition”.

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> **Max Verheijen, Cardano**

Banks say they aren’t too concerned, as they tend to hedge the discount changes. “If your mark-to-market changes because LCH or Eurex adopts a new discounting curve and they construct a discount curve based on Saron, which is 10bp lower, for instance, then you will get changes that you will see in the book. But on the other side, we will have hedged ourselves through these fixed-versus-Tois swaps, which should be effective in the same way," says the European bank's interest rate swaps trader.

However, buy-side firms could be exposed if they haven't entered similar hedges. Having been subjected to similar effects in the past, Cardano's Verheijen says swaps users should think about mitigating any negative impacts of the change in the discount curve on portfolios. He suggests resetting portfolios to current market conditions ahead of the introduction of the Saron discount curve. In a reset, the current mark-to-market is settled, after which a new discount curve can be used without any impact.

"If the difference between the fixed rate and the prevailing market rate is zero, I'm actually trading at-market, so there is no mark-to-market discounting issue," he says. "Going forward, we could then switch to Saron for our new cash collateral and use that as the discount rate, which would not need to be adjusted. That's one way of solving the problem, and it's the same method we use when we change the type of collateral we pay on a contract."

Contractual tensions

With the prospect of a potentially divergent new discount rate being applied to Libor-linked Swiss franc interest rate swaps in the near future, it is conceivable that some counterparties will seek to free themselves from their contractual obligations.

Olivier Favre, a partner at Swiss law firm Schellenberg Wittmer in Zurich, says he expects counterparties to enter into a so-called amendment agreement specifying the replacement of Tois with Saron to ensure an orderly transition. In the absence of such an agreement, the legal options will depend on whether the trades were signed using an Isda master agreement or a Swiss law master agreement.

"For transactions entered into under Isda agreements, Swiss courts would defer to English or New York law – as specified in the agreement – to determine whether Saron should be deemed the replacement rate of Tois," says Favre.

If the contracts include so-called fallback clauses that allow for alternative ways of obtaining a reference rate should the regular one be unavailable, then this would be easy. But an absence of such clauses could lead to lead to terminations based on contractual frustration – a situation where something renders performance of contractual obligations impossible. Legal experts dismiss this as **unlikely**.

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> **Olivier Favre, Schellenberg Wittmer**

Swiss master agreements, meanwhile, provide that in the event of a rate's discontinuation, a new rate would be applied, which would be the average of the rates quoted by four prime banks, mutually selected by both parties.

In these circumstances, it's unclear whether the banks should continue to quote a Tois rate or whether it would be possible under the terms of the contract to quote the new Saron rate. Once again, if parties do not enter into an amendment agreement specifying the application of Tois for the trade, some may see the difference in level between Tois and Saron as giving rise to a termination event under an agreement governed by Swiss law.

"To answer this, a court would have to decide whether the transition from Tois to Saron should be implied in the terms of the contract and any changes in valuations be compensated by the counterparty under the rules governing adjustments of contracts," says Favre.

The court would also have to consider "whether the replacement of Tois by Saron should be classified as a *force majeure* event that gives rise to a termination right for the affected transactions," he adds.